DOW THEORY LETTERS INC.

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THE MARKET: On October 7 the D-J Rail Average rallied above its 224.91 peak, a high that was recorded a year ago in October, 1964. On October 11 the D-J Industiral Average rose above its own 939.62 high, a high that was established five months ago in June, 1965. The significance of new record highs in the two Averages was discussed in Letter 301, Page 2. At that time I stated that new highs would, in my opinion, constitute a reconfirmation (or continuance) of the primary bull trend which began sixteen years ago on June 13, 1949. I further wrote that new highs would not mean that "a new bull market" had started in June, 1965, following a minor bear market.

The question might be asked: why bother with tedious classifications after the event? Isn't it enough to recognize that the primary trend of the market continues bullish? My answer is that classification is very important, and that it makes a great deal of difference whether a sixteen year old bull market has been reconfirmed or whether a new bull market has started. This is why.

Bear markets by their very nature tend to correct the excesses of the preceding bull market. Bear markets may correct in both time (duration) and degree(extent). Thus, most bear markets tend to last about one-third as long as the preceding bull market while often erasing one-half or more of all the preceding bull market gains. Occasionally, we will see a bear market which is abnormally shallow in degree. When this occurs, the bear market usually makes up for it by being abnormally long in duration. Conversely, some bear markets have been unexpectedly short in duration, but they have usually compensated for this by being violent and deep.

The fact is that we have had a number of important declines since the post-war bull market started in 1949. These occurred in 1953-54, 1956-57, 1960, 1962, and the latest 100 point drop of 1965. But none of the reactions have served to correct the entire rise since 1949. Furthermore, none of these declines were accompanied by the usual economic deflation which, history suggests, is seen during every true primary bear market. Thus, if one studies a chart of the Federal Reserve Board Index of Industrial Production through the years 1949 to date, it becomes apparent that the entire rise in this Index has held within well-defined ascending channel lines, the lower trendline of this channel connecting the 1949 and 1958 recession lows. At no time has there been a real bear market correction of the entire rise in the F. R. B. Index, the type of correction which is generally associated with a true bear market.

What does all this mean? It means that the bull market should be taken as extending. We should not interpret last week's new highs as indicating "a new primary bull market." A true

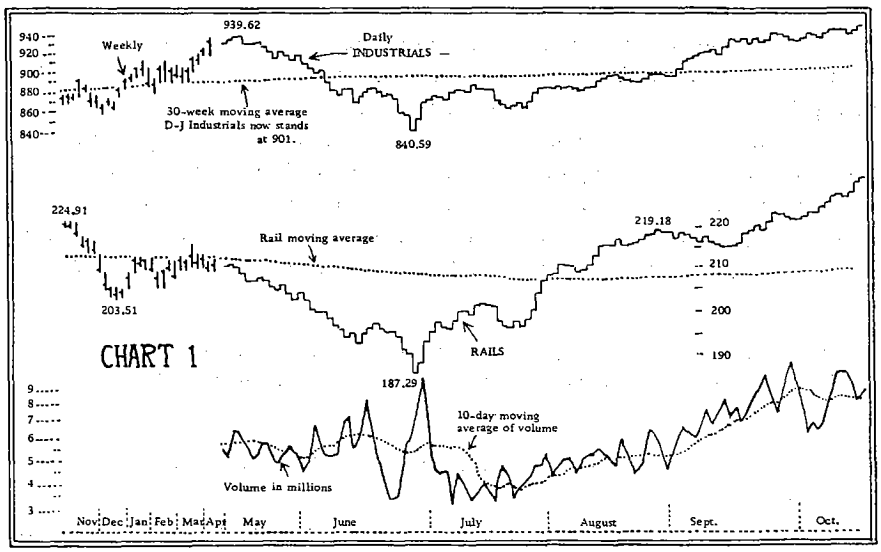
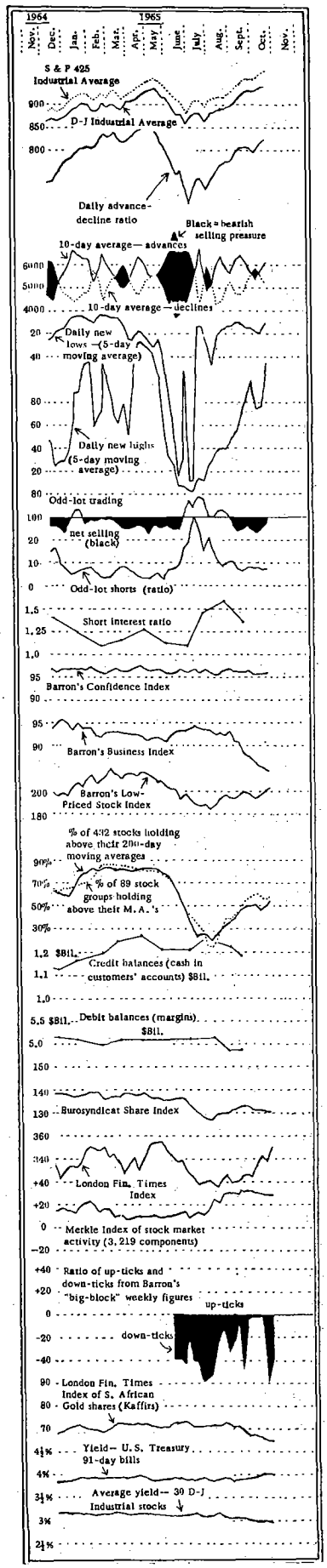


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average—advances
10-day average—declines
Daily new lows —(5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
Net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 482 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield— U.S. Treasury 91-day bills
Average yield— 30 D-J Industrial stocks

D Wave Aug 23

bear market correction in stocks and the economy has not occurred since 1949 — such a correction, in my opinion, lies ahead. With the thought of a continuing sixteen year bull market in mind, the Dow Theory principle of successive reconfirmations becomes increasingly important. This is the rule which states that successive reconfirmations in a bull market carry less validity. Finally, there will be a reconfirmation prior to the final bull market peak (and to that extent the "last reconfirmation" will also be a "deceptive reconfirmation" in that it will occur just before the turn in the tide).

It is interesting to note that when the great post-war bull market was originally confirmed (the first bull signal) on October 2, 1950, there were few who either cared about or acted upon the Dow Theory bull market signal. The fact that the signal came following a period of great undervaluation in common stocks and following an area of extraordinarily low volume attracted only the most astute investors. The original bull signal of 1950 made no headlines, it created little or no public interest.

The reconfirmation of the bull market which came last week was a far different affair. It occurred amid average daily volume of almost 8 million shares, it received wide coverage and bullish interpretations in advisory services, newspapers and periodicals throughout the nation. It occurred fifteen years after the original market confirmation.

What are some of the "plusses" and "minuses" which have accompanied this and previous Dow Theory bull market signals? For one thing it is significant that the original confirmation of 1950 and the succeeding reconfirmations of 1954, 1958, 1960 and 1963 came within the context of periods of favorable bank credit as shown in the Bolton Tremblay Bank Credit studies. Yet last week's reconfirmation appeared within a period of unfavorable bank credit (bank credit turned unfavorable in June of this year — see Letter 301). It should also be remembered that Dow's Theory concerns itself with values. The October bull signal came with average yields on the Dow at 2.96%, near an all-time low. This is in sharp contrast with the original 1950 bull signal, given with average Dow yields of 6.4%. Moreover, the 1965 bull signal was given in a market which is already producing record average daily volume and in a market which is evidencing a great deal of speculative intensity. This is not the sort of atmosphere which invites sober investment money — it is a speculator's market.

LIQUIDITY AND GOLD: Letter 301 noted that one of the major world problems is the problem of liquidity for the "underdeveloped nations." So far, U. S. dollar deficits have been providing the liquidity with which the underdeveloped nations have been operating. It has been estimated that these 60 odd countries require about $10 billions of additional dollars each year in order to keep afloat. But if the U. S. is to correct its adverse balance-of-payments (to control its dollar outflow), where is the new world liquidity to come from? This is the problem which is disturbing our Secretary of the Treasury, Mr. Fowler, and it is the problem which prompted him to call the recent meeting of the International Monetary Fund.

The U. S. controlled I.M.F. would like to bring out a new currency, a currency which would serve as an international substitute for gold. In a recent column, economist Melchior Palyi wrote about the plans for "the new money." Palyi notes that "Two variations (of money) are under scrutiny (by the I.M.F.). The Triffin plan and similar concoctions propose a nonconvertible kind. This is, of course, out of the question; no self-respecting central bank accepts pure fiat money as part of its reserve.

"The Roosa plan makes more sense in this respect: the new money would be gold-convertible. But who should put up the gold? France and Germany are extremely reluctant to part with anything more than a modest fraction of their gold-convertible currencies, let alone their gold.

"And how many "croosas" — that is the name Roosa suggests — could be created? If the global central bank is conservatively managed (by whom?) it will produce mere drops in the bucket. If it speeds up the printing press, the new money will be presented for conversion into gold. The scheme will collapse.

"That is where the great debate about a world-wide currency reform stands now. It dangles in the clouds of wishful imagination."

* * * *

Meanwhile, the Free World's chief source of liquidity, the South African gold producers, have been shaken by the dire plight of their neighbor, Rhodesia. Prime Minister Ian Smith now threatens to pull Rhodesia out of the British Commonwealth, thereby frustrating Britain's desire for majority rule in Rhodesia. But with four million blacks and only 217 thousand whites in Rhodesia, the fears of the white Mr. Smith regarding majority rule are understandable (even if morally unjustified). Mr. Smith has therefore threatened to take Rhodesia out of the Commonwealth, and Britain in turn threatens dire consequences if Rhodesia declares "unilateral independence." So far, both sides have been bluffing to the hilt, but all the world wonders what will happen if either side's bluff is called.

Neighboring South Africa is fearful of being drawn into the fray, for if economic sanctions are used against Rhodesia (to pressure her into majority rule), S. Africa may feel obliged to support Rhodesia through the struggle. This cooperation could lead to obvious further explosive problems. This writer believes that both sides (who are well aware of the dangers) will ultimately "give a little," and that the crisis will be averted. But in the meantime, the African gold shares are nervous and lower.

What are some of the plusses in the current picture? The plusses, it seems to me, are all on the technical side of the ledger. First there is the fact that the N.Y.S.E. now lists a record 7.8 million shares of shorts. This is admittedly a large number of people to be betting on the demise of the market; they could easily be wrong (or right too soon). Second, odd-lot volume as a percentage of total N.Y.S.E. volume is now running at record lows, around 7%. This is not characteristic of a market top. Third, since 1962 (when the advance started) odd-lotters have never shown any desire to purchase more shares than they have sold. Most major tops have formed with prior evidence of a change in sentiment among odd-lotters — a change towards the buying side of the market. Finally, the period since September, 1965, has been accompanied by record volume on the N.Y.S.E. Most advances do not top out on huge volume; they establish a further high on decreased volume (although the potential fallacy is this argument was discussed in the last Letter).

Conclusion: I continue to advise caution. The best bull argument here (it seems to me) is that the greatest bull market in history is likely to end up with the greatest amount of sheer speculation ever seen. But I am reminded that Robert Rhea advised against betting on how high a speculative move would carry. "How hot is hot?" he warned.

FURTHER OBSERVATIONS: On September 16 the Industrials rose above the 930 level. In the 22 trading days since then, 182 million shares of stock have changed hands (an average daily volume of 8.0 million shares). Yet in that period the D-J Industrial Average has advanced less than 20 points, a little better than 2%. This would seem to represent "churning." Put another way, since September 16 it has taken 10 million shares to move the D-J Industrial Average up each point. What we are probably seeing

is the greatest supply-demand struggle on the N.Y.S.E. in a generation.

The Composite Chart on Page 1 shows the two leading industrial averages at all-time highs with the A-D ratio moving up but still not confirming (by bettering its May peak). The 10-day average of advances shows buying power again in the dominant position. New highs (5-day average) rose to 118 last week, moving higher but still below the year's high of 149 recorded April 19. Odd-lotters are reducing selling somewhat, in response to a rising market (normally they increase selling). If this trend continues, it would be a hint of near-term weakness. Barron's Confidence Index rose two tenths to 96, while Barron's Business Index dropped to a new low for the year at 84.7. The short interest will be announced this week, and the eyes of all Wall Street will be on this figure. Since average daily volume on the N.Y.S.E. has been running around 7 million shares, the short interest ratio could decline into neutral or negative territory around 1.0 unless there is a good increase in the short interest total. The percentage of stocks holding above their moving averages rose above the critical 50% level to 54% last week, a plus sign for the market. The London stock average continues to follow our markets, last week advancing to the 348 area. The Big Block (over 10,000 share transactions) ratios again evidenced big money distribution, with last week's new high total of 63 Big Blocks showing five on "up-ticks" and twenty-nine on "down-ticks" (a ratio of minus 38). The S. African gold index slid to 64.9 last week, but this index is now giving ground grudgingly. The adverse spread between Treasury bill yields and the yield on the DJI holds at an extraordinary 1%, reflecting a speculative market which is anticipating more inflation.

Conclusion: Price action indicators continue to point up, but enough of the indices on this chart are negative to warrant caution on the part of investors.

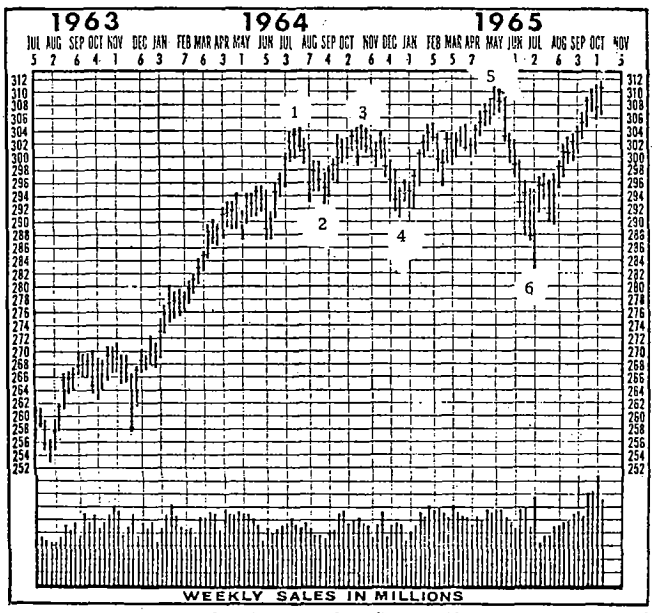
MONEY BATTLE: The following is by courtesy of the Janeway Letter of October 11 (311 East 50 St., N.Y.C., N.Y. 10022). I consider Janeway one of the most astute and knowledgeable students of politico-economics, and his observations on these subjects often appear weeks or months ahead of general recognition by Wall Street or other news sources.

"The Johnson Administration has now lost control over the money market. This is a development of the first importance; in our judgment, its repercussions are bound to be disturbing to the Government-Business relationship. If so, the consequences will be bearish out of all proportion to any temporary benefits accruing to lenders pressing for half a point here or there.

"Meanwhile, the bullish play which the Johnson Administration started when it created the money market conditions it wanted — and still wants! — is suspended. We don't expect to see these conditions reactivated for some months. Press speculation on whether the Administration will or won't go along with the upward interest rate spiral now in process misses the point. The money market play has got away from the Administration for the time being. What this poses is less a question of policy than a problem of power.

"Before LBJ can find a way to get the ball back (and we expect he will next year, before the 1966 Congressional elections), the odds are rising that the Administration and the banks will get involved in what both want least and fear most: a head-on collision. It would be wishful to think that any collision between the Administration and the banks could be localized to the banks (any more than Kennedy's row with Blough could have been localized to the steel industry). It is unfortunate, and it is bearish for the short term, that Johnson should have lost control over his money operations just when he happened to lose control over Congress (as the fiasco over 14B is now making official). The big new push towards Congressional independence is certain to make a capital of Johnson's loss of control over the money market, and of his impending collision with the banks."

EXTRAORDINARY PATTERN: Often the configurations of one stock average will point up a pattern which is not immediately apparent on another average. I have written at length regarding the "broadening structure" which has been forming in the D-J Industrial Average (Letters 299 and 300). The accompanying chart of the New York Herald Tribune 100 Stock Average brings out the broadening aspects of the movement even more dramatically than does the D-J Industrial Average. On the weekly Tribune chart we see six completed reversals since mid-1964 with the most recent rise (since June, 1965) having pushed slightly above the last peak reversal at 5. What this chart really depicts is a series of seven violent changes in Wall Street sentiment with first the buyers, then the sellers, gaining control of the market. Now, as volume mounts to 7 to 10 millions shares daily, we can sense this giant "battle of investment opinion" continuing.



New York Herald Tribune's 100-stock averages by weeks

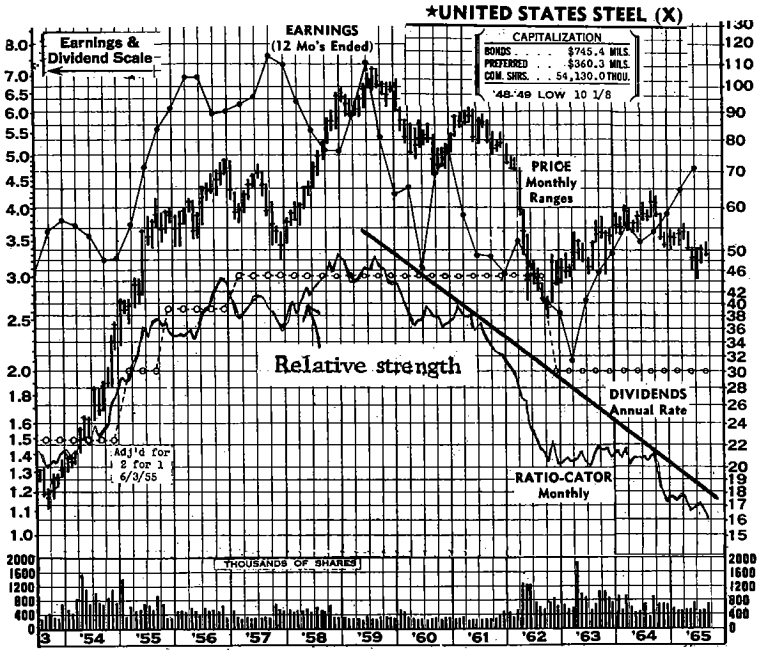
Note: of interest is the following from a report by Mr. Anthony Gaubis on December 15, 1964: " The N. Y. Herald Tribune 100 Stock Average is probably the best practical short-term indicator of the stock market as a whole. This is true because the Index is based on 100 leading stocks as compared with a much smaller number of issues which make up the Dow Jones and N. Y. Times Average."

CONFIDENCE: In the last Letter I commented regarding consumer confidence. Confidence regarding the general outlook, however, is not now confined to the American consumer. Note these two observations from the current issue of Business and Investment Timing (published by Anthony Gaubis): "(1) The holdings of cash or the equivalent in relation to assets of corporations now appears to be at an all time low. (2) At the same time, bank loans now represent a larger proportion of bank assets than has been the case at any time since 1929." Businessmen, it would seem, are now every bit as confident as are the consumers.

STOCKS: Traders Research (1431 Pearl St., Alton, Illinois 62003) lists the five following stock groups as strongest on the basis of relative strength intermediate term performance cycles: (1) Airlines, (2) Sulphur, (3) Aircraft, (4) Photography, (5) Textiles. The following are the five weakest groups: (42) Tobacco, (43) Paper, (44) Building Supply, (45) Cosmetics, (46) Amusement.

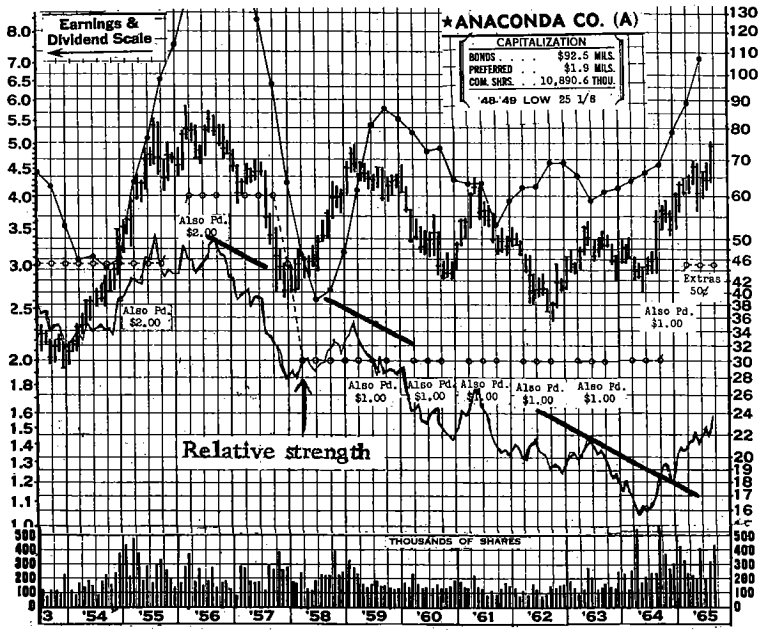
Traditionally bull markets have ended with "blow-off" moves in many individual stocks. Furthermore, the coppers, steels, rails and "low-priced" issues are the traditional groups which "blow their tops" when a great bull market ends. Along these lines, it is worthwhile studying long term (monthly) charts of two of the D-J leaders, Anaconda (a copper) and U. S. Steel (steel).

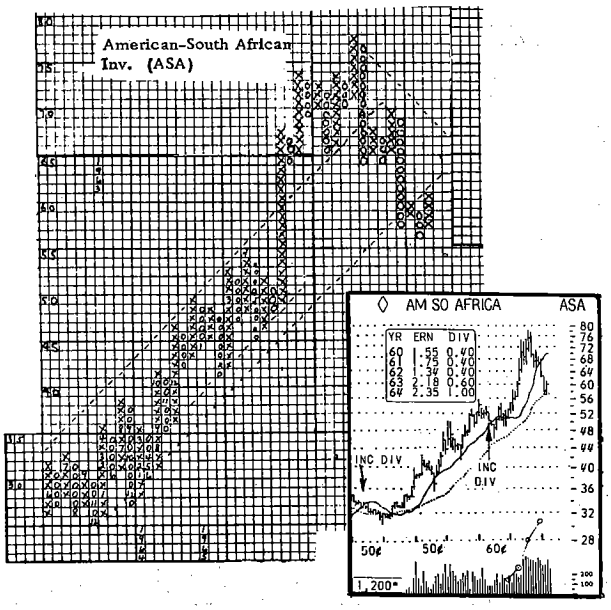
U. S. Steel's bull market was completed in three giant upward swings starting in 1949 (the chart shows only the 1953-56 and 1956-59 rises in Steel). From 1959 to 1962 Steel completed a three leg (two down and one up) bear market. So far, there is little in Steel's chart to suggest that it (or the Steel Group) will lead the market in the time-honored blow-off. Steel would have to better 65 to give evidence of a major reversal of its bear market which began in 1959.



Anaconda shows more promise of a speculative wind-up. It has moved well above its secondary peak of 54, after completing (in 1962) a major bear market. Anaconda has also reversed a seven year downtrend in relative strength, as evidenced by the rise in the R. S. line above the heavy black trendline.

Conclusion: Coppers, Rails and low-priced stocks are now acting much as they should in the final phase of a bull market. Only Steels have failed to enter the party.


★ANACONDA CO. (A)
Earnings & Dividend Scale
CAPITALIZATION
BONDS . . . . $92.5 MILS.
PREFERRED . . . $1.0 MILS.
COM. SHRS. . . 10,890.6 THOU.
'48-'49 LOW 25 1/8
Also Pd. $2.00
Also Pd. $1.00
Extras 50¢
Relative strength
THOUSANDS OF SHARES
'54 '55 '56 '57 '58 '59 '60 '61 '62 '63 '64 '65



American-South African (gold) has undergone an important correction and would appear to be in an advantageous accumulation zone again. After pushing above its long-term channel, it formed a top with a high at 77 (see point & figure chart). When it touched 64 it broke an important support point and this gave a P & F count to 50 (counting across the "top" which is 14 squares horizontally provided a downside objective of 50, or 14 points below the breakdown point at 64). Note that ASA corrected to only 57, and most recently a little "bottom formation" has been built. On October 18 ASA touched 61, thereby bettering its last peak and turning the stock bullish again. It would be particularly hopeful if ASA retreated again to around 57-58, thereby building a larger base before pushing up again (as long as ASA holds above 56 it will now be classified as bullish). As seen on the small chart, ASA has stopped exactly at its 30-week moving average (dotted line) which now stands at 56.

Large monthly charts courtesy of Securities Research, 211 Congress St., Boston, Mass. 02110.
Small chart of ASA courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.
P & F chart of ASA courtesy of Chartcraft, Larchmont, New York.